

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:PEN:PIT:TL-N-4963-99  
DPLeone

date:

to: Kathy J. Beck

from: Associate District Counsel, Pennsylvania District, Pittsburgh

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subject:

**[REDACTED] Letters - Alleged inadvertent disclosure of documents protected by attorney-client and/or attorney work product privileges**  
UIL NO. 9999.98-00 - Misc. Issue Not Able to Identify Under Present List

This advice has been sent to the National Office for 10-day post-review. Accordingly, there is a possibility that the conclusion reached herein will be changed. The team should contact Donna Leone on September 25, 2000 to see if this advice has been modified or changed by the National Office.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

1. The taxpayer has alleged that certain documents were inadvertently turned over to the Internal Revenue Service and that those documents are protected by the attorney-client or attorney work product privileges. The taxpayer has demanded a return of the documents. Must the Internal Revenue Service return the documents, or is the Internal Revenue Service free to use the documents?

ANSWER

1. The Internal Revenue Service does not have to return the documents, and may use the documents in the 30-day letter as proposed by the agent.

FACTS

██████████ is a parent whose subsidiaries include a ██████████. This question arose in connection with the CEP audit of the tax years ended December 31, ██████████ and December 31, ██████████. A Revenue Agent's Report and a thirty-day letter had been issued for this cycle, and a protest to the RAR was submitted on ██████████. There are only two unagreed issues for this cycle: a disallowance of \$██████████ of rental expenses and the assertion of the accuracy-related penalty under section 6662(b)(1) or, alternatively, section 6662(b)(2).

The disallowed rental expenses relate to a ██████████ leasing transaction entered into by ██████████. ██████████ is a subsidiary of ██████████. ██████████ is an unregulated subsidiary of ██████████ that is involved in leasing and other investments on behalf of ██████████. ██████████ and ██████████ file a consolidated tax return.

██████████, an independent leasing company, acquired ██████████ equipment subject to ██████████. ██████████ leases (the "User Leases") with independent third parties ("Users"). ██████████ financed the acquisition in part with nonrecourse notes obtained from independent financial institutions ("Senior Debt"). The loans were secured by the User Leases.

On ██████████, ██████████ sold the equipment to ██████████ ("Owner Trust"). The Trust's beneficiary is a partnership of individuals organized under the laws of England ██████████. The Owner Trust assumed the Senior Debt on the equipment and issued a recourse equity note to ██████████ for the balance of the purchase price and a small non-recourse promissory

note.

Upon purchase of the equipment, the Owner Trust leased the equipment to another Delaware business trust, the Lessee Trust, for a term of sixty months ("Master Lease"). The Lessee Trust is owned and controlled by [REDACTED], a general partnership organized under the laws of England, and that is wholly-owned by two individual residents of England. The Lessee Trust has the right to receive the rentals from the users of the equipment, a right of the Owner Trust assigned to the Lessee Trust and included in the User Leases. The term of the various User Leases is approximately two years less than the term of the Master Lease.

On [REDACTED], the Lessee Trust sells the right to receive the rentals from the users of the equipment to unrelated third parties (User Rent Purchasers) for \$ [REDACTED]. The \$ [REDACTED] is treated as a deposit and is held by an independent third-party, [REDACTED], to secure the obligation of the Lessee Trust under the Master Lease, which obligation in turn serves as collateral for the computer equipment.

Also on [REDACTED], the Owner Trust refinanced the existing Senior Debt with new indebtedness ("Replacement Debt") issued by a bank wholly unrelated to the holders of the Senior Debt and the User Rent Purchasers. The Replacement Debt has a term of sixty months and is to be repaid from the Master Lease rentals.

Following the sale by the Lessee Trust of the rental payments, the Lessee Trust transfers its assets (the \$ [REDACTED] "deposit" and the right to re-lease the [REDACTED] for the period between the end of the User Leases and the end of the Master Lease) and its obligation to pay rent under the Master Lease over a period of five years (approximately \$ [REDACTED] per year, for a total of \$ [REDACTED], to [REDACTED] in exchange for preferred stock of [REDACTED]. The liquidation value of the preferred stock is \$ [REDACTED], and pays a dividend of \$ [REDACTED] per year, quarterly. There was also a minimum of \$ [REDACTED] paid by [REDACTED] as transactional costs.

This leasing transaction has been referenced by the parties as [REDACTED], and was entered into by [REDACTED] on [REDACTED].

On [REDACTED], [REDACTED] entered into three other lease stripping investments referred to by the parties as [REDACTED].

On the [REDACTED] consolidated return, \$ [REDACTED] was claimed as

a rental expense by [REDACTED] for the [REDACTED] and [REDACTED] transactions. The \$[REDACTED] was disallowed in full by the Examination Division on a number of alternative grounds (e.g., sham transaction; not ordinary and necessary business expense under section 162; matching income to deductions using section 482; step transaction). If the rental expense cannot be disallowed in full, Examination determined that it was overstated by approximately \$[REDACTED]. However, the taxpayer now asserts that it failed to amortize the \$[REDACTED] cash outlay, and additional costs identified as transaction costs, when entering into the transaction.

On [REDACTED], the Revenue Agent's Report ("RAR") was issued. In response to the RAR, a Protest dated [REDACTED] was filed. The protest included facts and information that were not submitted as part of the initial audit. In response to the Protest, in order to address the new information, the Examination Team issued eleven Form 4564, Information Document Requests ("Protest IDRs"). The Protest IDRs were submitted to the Director, Tax Audits. The taxpayer responded to the Protest IDRs by giving the team a big box (approximately 3 feet long) filled with information. Inside the box were file folders identified as being in response to a certain Protest IDR. Protest IDR 7 and 8 were answered by the taxpayer with two file folders. Inside the file folders were numerous memoranda from outside remarketing agencies and miscellaneous information such as future cash flow projections.

Additionally, in the folders for Protest IDR 7 and 8, there were six [REDACTED] memoranda or letters (hereinafter "[REDACTED] memorandum"). Not all of these documents were exact duplicates, but appeared to be different draft copies of the memorandum. The drafts were dated [REDACTED], [REDACTED], and [REDACTED]. The [REDACTED] memorandum contained an opinion of the federal income tax consequences of the [REDACTED] leasing transaction. The opinion was given after [REDACTED]'s entry into [REDACTED], but prior to [REDACTED]'s entry into three similar lease stripping arrangements referred to as [REDACTED].

The draft copies of the [REDACTED] memorandum were sent under a [REDACTED] fax cover sheet to [REDACTED], identified the subject matter as "[REDACTED]", and contained a request that the copy be delivered to [REDACTED]. [REDACTED] was the Vice President of [REDACTED] and Treasurer of [REDACTED]. [REDACTED] was the individual responsible for entry into these lease transactions. The fax cover sheet contains the following disclosure legend at the bottom:

This message is intended only for the use of the

individual or entity to which it is addressed and may contain information that is privileged, confidential and exempt from disclosure under applicable law. If the reader of this message is not the intended recipient or the employee or agent responsible for delivery of the message to the intended recipient, you are hereby notified that any dissemination, distribution or copying of the communication is strictly prohibited. If you have received this communication in error please notify us immediately by telephone and return the original message to us at the above address via the U.S. Postal Service. Thank you.

The first page of the draft [REDACTED] memoranda included the legend "Privileged and Confidential" above the intended recipient's address block.

In addition to the [REDACTED] memorandum, a spreadsheet prepared by [REDACTED] with respect to [REDACTED] under cover of a memorandum statement referencing a conversation between [REDACTED] (of [REDACTED]) and [REDACTED] was sent by facsimile to [REDACTED] and was turned over with the responses to Protest IDRs 7 and 8. The fax cover sheet contained the same language noted above, but the attached memorandum and spreadsheet did not contain any assertion of privilege or confidentiality.

Upon receipt of the [REDACTED] memorandum, Examination faxed a copy to District Counsel and to the ISP-Examination for leasing.

The [REDACTED] memorandum was not directly responsive to Protest IDR 7 or 8. However, Protest IDR 7 contained a rather broad request for "leasing transaction files". The [REDACTED] memorandum could conceivably be a part of such file. Accordingly, the inclusion of the [REDACTED] memorandum in response to Protest IDR 7 is not clearly unresponsive to the request. (Note that Protest IDR 2 requested various written correspondence to or from [REDACTED]'s counsel. Accordingly, the Protest IDRs did ask for copies of written communications between [REDACTED] and counsel).

On [REDACTED], the Examination Team interviewed [REDACTED] concerning the [REDACTED] and [REDACTED] leases. The law firm of [REDACTED] are counsel for [REDACTED], and a lawyer from [REDACTED] was present at the meeting. [REDACTED] had issued a favorable tax opinion on the [REDACTED] leases, and that opinion had been provided to the Internal Revenue Service. During the interview, the favorable tax opinion of [REDACTED] was discussed. Revenue Agent Ellen Pawlowski asked if [REDACTED] had received any unfavorable legal opinions. [REDACTED] said

that no unfavorable opinions were received. Pawlowski then showed [REDACTED] a memorandum outlining whether the transaction was economically sound without consideration of tax benefits, including a listing of law firms that would, or would not, give a favorable tax opinion on the transaction. This memorandum referenced the [REDACTED] memorandum, and identified [REDACTED] as a firm that would not give a favorable opinion. The author of this particular memorandum is not stated and it is unclear at this time who actually authored this memorandum.

Pawlowski also showed [REDACTED] a copy of the [REDACTED] memorandum. [REDACTED] then indicated that [REDACTED] addressed all of the concerns in the [REDACTED] memorandum and relied on [REDACTED]. [REDACTED] then said that he did not think that the [REDACTED] memorandum was an unfavorable opinion. [REDACTED] further stated that [REDACTED] did not engage [REDACTED] for a tax opinion prior to entry into the transaction. Rather, the [REDACTED] memorandum was an after-the-fact memorandum prepared to help [REDACTED] manage the process in the event the item was picked up on audit.

On [REDACTED], [REDACTED] sent a misaddressed letter to "Case Manager" [REDACTED] and demanded a return of the [REDACTED] memorandum. ([REDACTED] is the Team Coordinator, [REDACTED] is the Case Manager). [REDACTED] indicated that they did not see the letter and were not fully aware of the nature or contents of the letter during the meeting held on [REDACTED]. Upon their investigation [REDACTED] determined that the letter was marked "Privileged and Confidential". [REDACTED] asserted that the [REDACTED] memorandum

contains legal advice that is protected by the attorney-client and attorney work product privileges. The taxpayer did not intend to give that letter or any associated materials prepared by that law firm to the Internal Revenue Service. The production of that letter and associated materials was inadvertent and unintentional. The taxpayer did not and does not waive its privileges with respect to the letter or the advice contained in it and requests that the Internal Revenue Service immediately return all copies of the letter to us.

As of this date, the letter and related materials were not returned to [REDACTED]. [REDACTED] have been informed that the Examination Team has sought legal advice on the request for a return of the materials.

The Examination Team plans on including the [REDACTED] memorandum in their rebuttal to the protest in the following ways:

- a) Attached as an exhibit to the rebuttal;
- b) To show that [REDACTED] lied when he denied receiving any unfavorable opinions;
- c) To show that the [REDACTED] opinion supports Examination's primary position and alternative positions; and
- d) To show that the taxpayer did not exercise due diligence when it investigated the [REDACTED] transactions (particularly [REDACTED]), and should be responsible for the accuracy-related penalty.

#### DISCUSSION

[REDACTED] asserts that it has inadvertently disclosed documents protected by the attorney-client privilege or the attorney work product privilege to the Internal Revenue Service, and that the Internal Revenue Service is obligated to return the documents and cannot use the documents.

For purposes of this response, it is assumed that the documents are covered by either the attorney-client privilege or the attorney work product privilege. However, it may be that these privileges do not apply to these documents. Accordingly, the applicability of these privileges to the documents in question is an issue that should be reserved and not conceded by the Service at this time.

The attorney-client privilege protects confidential communications from a client to a lawyer given in the course of seeking legal advice. The privilege also extends to the legal advice given by the lawyer if the disclosure would directly or indirectly reveal the information received from the client. The privilege, or the protection of the privilege, may be waived.

It is well-settled law that, if the communication has been purposefully disclosed to a third party, the privilege is waived. The question presented here is whether an inadvertent disclosure constitutes a waiver of the privilege. The inadvertent disclosure issue is currently in flux in the courts, and three basic avenues to analyze this situation have developed: a) the strict approach in which disclosure always waives the privilege, even inadvertent disclosure; b) the lenient approach in which there can be no waiver without intent, so there is no waiver for an inadvertent disclosure; and c) the balancing approach that

looks at the totality of the circumstances to determine whether there has been a waiver. Trina Jones, *Inadvertent Disclosure of Privileged Information and the Law of Mistake: Using Substantive Legal Principles to Guide Ethical Decision Making*, 48 Emory L.J. 1255, 1272 and 1321 (1999).

No controlling case law has been found for the Third Circuit. No United States Tax Court cases addressing this issue have been found.

The lenient approach, which holds that there can be no waiver without intent, is a minority position. This position should not be followed by the government in this case.

The government should advance the strict approach that the disclosure, even if inadvertent, waived the privilege. In re Sealed Case, 877 F.2d 976, 980 (D.C. Cir. 1989); Carter v. Gibbs, 909 F.2d 1450, 1451 (Fed. Cir. 1990); In re United Mine Workers of America Employee Benefit Plans Litigation, 156 F.R.D. 507 (USDC D.C. 1994). [REDACTED] had an obligation to protect the privilege by exercising utmost care not to waive the protection of the privilege. Having failed to exercise the requisite care, [REDACTED] cannot undo the mistake.

The balancing approach, or the totality of the circumstances approach, has been used with increasing frequency, *Inadvertent Disclosure*, 48 Emory L.J. 1255, 1274 n. 61, and may be the approach adopted by either the United States Tax Court or the Court of Appeals for the Third Circuit. The factors which the courts have looked at in the balancing test are:

- (1) the reasonableness of the precautions taken to prevent inadvertent disclosure;
- (2) the time taken to rectify the error;
- (3) the scope or extent of the discovery;
- (4) the extent of the disclosures;
- (5) the number of the inadvertent disclosures;
- (6) the degree to which the inadvertently disclosed materials have been incorporated into the opposing parties' case; and
- (7) the overriding issue of fairness (i.e., would the interests of justice be served by relieving the party of its mistake?).

Hydraflow, Inc. v. Enidine Incorporated, 145 F.R.D. 626, 637 (W.D.N.Y. 1993); *Inadvertent Disclosure*, 48 Emory L.J. 1255, 1272.

The balancing test basically analyzes whether [REDACTED] was diligent in trying to protect its privilege, so that a finding can be made that the documents were released despite [REDACTED]'s best efforts and careful controls. If [REDACTED] was careful, but a disclosure was made anyway, a court would be inclined to find no waiver under the balancing test. If, however, [REDACTED] was negligent or deficient in how it decided what to turn over to the I.R.S., then the courts should find that [REDACTED] did not work hard enough to protect the privilege and the privilege should be deemed to be waived. The "intent" of [REDACTED] is determined by how carefully [REDACTED] tried to protect the privilege. Hydraflow, 145 F.R.D. at 637. Similarly, if the person responsible for determining what had to be turned over to the I.R.S. made a deliberate decision to turn the documents over, the court should find that the turnover should not even be considered to be inadvertent and that there was a waiver. Simply because the individual did not realize the import of the document being turned over does not make the production inadvertent if [REDACTED] did not have sufficient controls and simply allowed a non-lawyer to prepare the IDR response and to turnover the documents without counsel's review.

(b)(7)a, (b)(5)(AWP)

(b)(5)(AWP), (b)(7)a

(b)(5)(AWP), (b)(7)a


(b)(5)(AWP), (b)(7)a

(b)(5)(AWP), (b)(7)a

(b)(5)(AWP), (b)(7)a



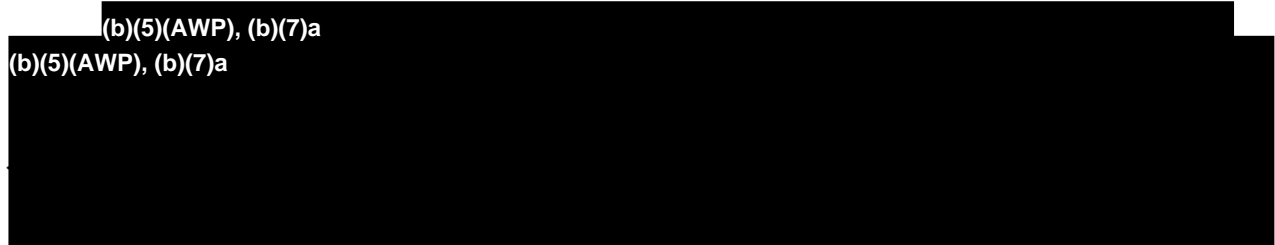
(b)(5)(AWP), (b)(7)a  
(b)(5)(AWP), (b)(7)a



(b)(5)(AWP), (b)(7)a



(b)(5)(AWP), (b)(7)a  
(b)(5)(AWP), (b)(7)a

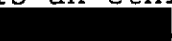


(b)(5)(AWP), (b)(7)a



Thus, under the balancing test, we believe that the privilege has been waived.

Finally, we have considered the ethical, as well as legal, implications of keeping the communication. The American Bar Association has issued an opinion that, when a lawyer receives materials that on their face appear to be subject to the attorney-client privilege or otherwise confidential, that the lawyer has an ethical duty to refrain from viewing the materials and must notify the sending lawyer of the receipt of the materials and abide by the instructions of the sending lawyer as to return of the materials. ABA Formal Ethics Opinion 92-368.

The ABA Opinion has not been adopted uniformly by the state bars. Additionally, there are bodies charged with enforcing and/or interpreting legal ethics that have disagreed with the conclusions reached in the ABA Opinion. See, Philadelphia Bar Association Professional Guidance Committee, Opinion Nos. 94-3 (June, 1994) and 94-15 (September 15, 1994). Accordingly, we do not believe that there is an ethical constraint on the refusal to return the documents to .

For the above-stated reasons, we conclude that the documents do not have to be returned to [REDACTED], and that the revenue agents can use the documents in the 30-day letter.

If you have any questions, please call Donna P. Leone at 412-644-3442.

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EDWARD F. PEDUZZI, JR.  
Associate District Counsel